The Section 2519 Portability Solution permits state death taxes on the first decedent's federal estate tax exemption amount not only to be deferred but entirely eliminated. It is even possible to eliminate or nearly eliminate state death taxes on all assets passing from the first decedent. Almost all married couples who live or who may in the future live in states that impose a death tax, therefore, should consider executing documents that give the surviving spouse the choice of taking advantage of the Section 2519 Portability Solution.

Now, Austin Bramwell provides LISI members with his thoughts on what he refers to as the “Section 2519 Portability Solution.” As Austin points out in his commentary, an advantage of the Section 2519 Portability Solution for avoiding state death taxes is that it does not require the surviving spouse to relinquish wealth after the first decedent's death. And as Steve Groin points out in his Technical Editor’s comment, the “Section 2519 Portability Solution” is a nice contribution to our thought process in planning under today's crazy patchwork of federal and state estate taxes.

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Here is his commentary:

EXECUTIVE SUMMARY:

The new portability provisions, which permit a surviving spouse to inherit the unused estate tax exemption of a deceased spouse, have opened up a number of interesting new planning opportunities. For example, as Jonathan Blattmachr and Mitchell Gans discuss in LISI Estate Planning Newsletter #1965 (May 21, 2012) (hereinafter, "Blattmachr and Gans"), portability enables married couples to defer state death taxes until the death of the surviving spouse without wasting the first decedent's federal estate tax exemption amount. This article takes it one step further: not only does portability make it possible to defer state death taxes on the first decedent's assets but it enables married couples to avoid such taxes altogether.

FACTS:

The Decoupling Dilemma

Traditionally, the first decedent's estate was divided into two portions. The first portion, called the "credit shelter," "bypass" or "A" portion, was defined to be equal to the maximum amount that can pass free of estate tax at the first decedent's death. The second portion, called the "marital" or "B" portion, was equal to the balance of the first decedent's estate. The credit shelter portion would pass to a trust (known as a "credit shelter trust") for the benefit of the surviving spouse that did not qualify for the estate tax marital deduction. The marital portion would pass to the surviving spouse in a form that did so qualify. At the surviving spouse's death, the credit shelter trust would pass free of estate tax, thereby ensuring that the first decedent's estate tax exemption was not "wasted," even though all his or her assets were bequeathed to or held for the benefit of the surviving spouse.

In recent years, planning with credit shelter trusts has not worked as smoothly as it used to. For example, state estate tax exemption amounts since 2004 have not always kept pace with the federal estate tax exemption amount. The mismatch or "decoupling" of the federal and state exemptions has put married couples on the horns of a dilemma. On the one hand, to ensure that his or her federal estate tax exemption amount is not wasted, the first decedent could create a traditional credit shelter trust equal to the full amount of his or her remaining federal estate tax exemption amount. In that case, however, state death tax might need to be paid at the first decedent's death. A federal taxable estate of $5.12 million (i.e., the current federal estate tax exemption amount), for example, will produce $460,454.55 of New York State estate tax, if (as planners typically recommend) New York State estate tax is apportioned against the marital share.

On the other hand, the first decedent could limit the credit shelter trust to the state estate tax exemption amount. In that case, the first decedent's estate would generally have neither federal nor state death tax liability. A portion of the first decedent's federal estate tax exemption amount, however, would potentially go to waste, as the difference between the federal and state exemption amounts would pass...
Deferring State Estate Tax with State-Only QTIP or Portability Elections

As discussed in Blattmachr and Gans, there are now at least two ways to defer state death taxes until the surviving spouse's death without also wasting the first decedent's federal estate tax exemption amount. The first way is to have the first decedent bequeath an amount — sometimes referred to as the “swing share” — equal to the difference between the federal and state estate tax exemption amounts to a trust that can qualify for the marital deduction as “qualified terminable interest property” or “QTIP.” At the first decedent's death, his or her executors elect to treat the swing share as QTIP for state but not federal estate tax purposes. The federal taxable estate, because it includes the swing share, will use up the federal estate tax exemption amount in full. The state taxable estate, by contrast, because it does not include the swing share, will be limited to the state estate tax exemption amount. In this way, in those states that permit a state-only QTIP election, a married couple can use up all of the first decedent's federal estate tax exemption yet defer the payment of state estate tax until the surviving spouse's death.

The second way to defer state death taxes is to rely on the new portability provisions to preserve the first decedent's federal estate tax exemption amount. Specifically, the first decedent can limit the credit shelter portion to the state estate tax exemption amount and bequeath the balance of his or her estate to the surviving spouse in a form that qualifies for both the federal and state marital deductions. The first decedent's taxable estate will then be less than the federal estate tax exemption amount. His or her executors, however, can elect to permit the surviving spouse to use the first decedent's unused exemption amount. In this way, the first decedent's federal estate tax exemption amount will not go to waste, even though his or her taxable estate is limited to the (lesser) state estate tax exemption amount.

COMMENT:

Advantages and Limitations of Deferral

Deferral of state death taxes until the death of the surviving spouse has important benefits. First, more assets of the first decedent can remain available for the surviving spouse as opposed to being “prepaid” to a state government. Second, if state death taxes are deferred by relying on portability, the swing share assets can receive a step-up in basis for income tax purposes at the surviving spouse's death under section 1014(a) of the Internal Revenue Code (the "Code").

Third, in many cases, deferral of state death tax will ultimately result in state death taxes being avoided altogether. For example, the share qualifying for the state estate tax marital deduction could be consumed during the surviving spouse's lifetime and not included in his or her gross estate at death. The surviving spouse might also escape state death tax by changing his or her domicile to a state that does not impose a death tax. Consequently, if the surviving spouse might relocate after the first decedent's death, it may not in many cases be advisable to draft documents that will cause state death taxes to become payable at the first decedent's death.

On the other hand, deferral of state death taxes, whether by means of a state-only QTIP election or a portability election, may not always be tax-efficient. For example, if a state-only QTIP election is made and the swing share appreciates in value before the death of the surviving spouse, more state death tax will be due than if the swing share had been included in the state taxable estate at the first decedent's death. In addition, to qualify for the state-only QTIP election, the swing share trust must pay income at least annually to the surviving spouse. Any income paid to the surviving spouse will ultimately be included in his or her gross estate at death. To avoid federal and state estate tax on swing share income, it is better for the first decedent to add the swing share to the credit shelter trust (whose provisions can permit the income to be accumulated), even if that will cause state death tax to be paid at the first decedent's death.

Alternatively, if the portability election is made and the swing share appreciates in value before the surviving spouse's death, all such appreciation will be subject to both federal and state death tax at the surviving spouse's death. To be sure, the surviving spouse's estate would have the benefit of the first decedent's unused exemption amount. That amount, however, remains fixed during the surviving spouse's lifetime, even if the swing share appreciates in value. Reliance on portability, therefore, may cause more federal and state estate tax to be paid than if the first decedent creates a traditional credit shelter trust equal to his or her full federal estate tax exemption amount.

Finally, the techniques for deferring state death tax until the surviving spouse's death are not efficient from a generation-skipping transfer ("GST") tax perspective. To qualify for the marital deduction and also pass in a form to which GST exemption can be allocated, the swing share must be held in a trust that pays all income to the surviving spouse. Any GST exemption allocated to the swing share will be wasted to the extent that income is paid to the surviving spouse, as the surviving spouse is not a "skip person" with respect to the first decedent. More property can pass free of GST tax, by contrast, if the first decedent creates a traditional credit shelter trust equal to his or her remaining federal estate tax exemption amount, his or her executors allocate GST exemption to the trust and the trust terms permit income to be accumulated.

Avoiding State Death Taxes by Making the Portability Election and Having the Surviving Spouse Make Taxable Gifts

Where the surviving spouse is willing to make taxable gifts, the new portability provisions create a simple way to avoid state estate taxes on the first decedent's federal exemption amount. The first decedent simply bequeath all his or her assets to the surviving spouse, his or her executors make the portability election and the surviving spouse makes a gift to descendants equal to the inherited exemption amount.

Avoiding State Death Taxes Using the Section 2519 Portability Solution

For less wealthy couples, there is an alternative strategy, known as the Section 2519 Portability Solution, for avoiding state death taxes that does not require the surviving spouse to relinquish wealth after the first decedent's death. Under the strategy, the credit shelter portion is limited to the state estate tax exemption amount. The surviving spouse can then use a QTIP trust to pass the marital share to QTIP beneficiaries. The surviving spouse will have a non-zero taxable estate that may generate state taxes; the surviving spouse will not owe gift tax. The gift, meanwhile, will have the effect of transferring assets to the surviving spouse's gross estate, thereby depriving state governments of the chance to subject such assets to tax. To avoid wasting the first decedent's GST exemption, the first decedent's unused GST exemption should be allocated to a "reverse" QTIP trust; the surviving spouse should then make the gift to descendants out of other, non-GST-exempt assets.

A lifetime gift by the surviving spouse is especially tax-efficient if it is made to a long-term trust for descendants that is structured as a "grantor trust" for income tax purposes. The surviving spouse will then be liable for tax on the trust's taxable income (including capital gains), thereby enabling the trust to earn tax-free returns even as the surviving spouse's estate is depleted by the income tax liability. The surviving spouse can also enter into transactions with the trust that are ignored for income tax purposes. For example, the surviving spouse can sell assets to the trust that are expected to appreciate in value and/or acquire low-basis assets from the trust in order to obtain a "step up" in basis at the surviving spouse's death. For these reasons, very wealthy couples may wish to consider having the surviving spouse create inter vivos trusts for descendants rather than have the first decedent create a traditional credit shelter trust.

Avoiding State Death Taxes On All of the First Decedent's Assets

As discussed above, married couples can use section 2519 of the Code to avoid state death tax on the first decedent's federal estate tax exemption amount. They need not stop there: In principle, married couples can also exploit section 2519 to avoid state death taxes on all assets bequeathed by the first decedent. Specifically, if the first decedent leaves the marital share to one or more QTIP trusts, the surviving spouse can remove the marital share from his or her gross estate by assigning his or her income interests during lifetime, such as shortly before death. The assignments will not necessarily save federal tax, as they will be treated as taxable gifts under section 2519. Any gift taxes payable may also be included in the gross estate of the surviving spouse if he or she does not survive three years from the date of the deemed gifts.

On the other hand, deathbed gifts under section 2519 of the Code can eliminate nearly all state death taxes on assets passing from the first decedent, as the deemed gifts remove such assets from the surviving spouse's taxable estate. The elimination of state death taxes may not be total: Even if the surviving spouse dies with no other assets, gift taxes payable on the deemed gifts may be included in his or her gross estate under section 2035(b) of the Code. In that case, the surviving spouse will have a non-zero taxable estate that may generate state taxes.

[xv] As the amount of the gift does not exceed the sum of the surviving spouse's "basic" and inherited exemption amounts, the surviving spouse will not owe gift tax. The gift, meanwhile, removes the donated assets from the surviving spouse's gross estate, thereby depriving state governments of the chance to subject such assets to tax. To avoid wasting the first decedent's GST exemption, the first decedent's unused GST exemption should be allocated to a "reverse" QTIP trust; the surviving spouse should then make the gift to descendants out of other, non-GST-exempt assets.

[xvi] Nor, with proper planning and drafting, should the swing share be included in the surviving spouse's gross estate under any other section of the Code. In short, a deemed gift under section 2519 can remove the swing share from the surviving spouse's gross estate no less effectively than an actual gift. States that impose a death tax, therefore, will have no opportunity after the section 2519 gift to subject the swing share to tax.

[xvii] A deemed gift has the advantage, meanwhile, of permitting the surviving spouse to continue to receive distributions of principal. In addition, the deemed gift enables all income and appreciation on the swing share to pass free of estate tax that the surviving spouse's death. Finally, the surviving spouse's assignment will have no effect on any allocation of the first decedent's GST exemption to the swing share. Consequently, the swing share (including both appreciation and income, if the surviving spouse assigns the income interest to a trust for descendants) can ultimately pass not only free of state death tax but free of GST tax as well.
death taxes. Even if state death taxes are payable on gift taxes included in the gross estate, however, the state death tax liability will typically be only a fraction of the liability that would have been incurred had no deemed gifts been made prior to death.

In Summary

The Section 2519 Portability Solution permits state death taxes on the first decedent's federal estate tax exemption amount not only to be deferred but entirely eliminated. It is even possible to eliminate or nearly eliminate state death taxes on all assets passing from the first decedent. Almost all married couples who live or who may in the future live in states that impose a death tax, therefore, should consider executing documents that give the surviving spouse the choice of taking advantage of the Section 2519 Portability Solution.

TECHNICAL EDITOR'S COMMENTS

The author raises some excellent points about how to use what he calls the “swing share” – the portion that uses the federal estate tax exemption but with respect to which a state-only QTIP election has been made. This strategy would be beneficial if the following conditions are present:

1. The state does not impose a gift tax.
2. The state would tax the swing share only if included in the surviving spouse’s gross estate.

Even if these conditions are not present when one drafts now, they might be present when a married person dies. Let’s discuss whether drafting to be able to implement this strategy is inherently desirable and the likely presence or absence of these conditions.

Letter Ruling 201131011 asserted that one may not take a federal marital deduction for the swing share so as to avoid state death taxes. It reasoned the marital deduction would not save federal estate taxes and is therefore void under Rev. Proc. 2001-38. A number of practitioners expressed concern when this was issued that the Letter Ruling prevents someone from making a federal QTIP election to save state but not federal estate tax. Read very broadly, it would preclude the use of the “Section 2519 Portability Solution.” Presumably, Rev. Proc. 2001-38 should apply only when the taxpayer requests its application, a reading that appears supported by the last sentence of Section 4 of Rec. Proc. 2001-38. (Bramwell and Kanaga at 24 also suggest that the IRS is unlikely to invoke Rev. Proc. 2001-38 in the context of a lifetime gift and that the Revenue Procedure is no longer viable in any case.) You should examine the Letter Ruling and Revenue Procedure and decide for yourself. Suppose, however, that you agree with the author and the IRS later says that you were wrong. The IRS would not be imposing any additional tax on the first spouse’s death (since the Revenue Procedure applies only to the extent that no tax would be imposed on the first spouse’s death) and would be asserting that no gift tax is due under Code § 2519.

Although bequeathing the swing share to a surviving spouse outright has some surface appeal, it is rife with issues. The decedent’s GST exemption is wasted, and any gift that the spouse makes in which the spouse might be a beneficiary creates potential Code § 2036 issues and creditor issues. If the surviving spouse does not make a gift, any future appreciation is potentially subject to estate tax, as well as the entire outright share being subject to the rights of a new spouse and creditors. Placing the swing share in a trust for which a QTIP election has been made preserves the GST exemption and protects the assets from predators, whether or not one uses the “Section 2519 Portability Solution.”

How would one draft to implement the “Section 2519 Portability Solution”? Let’s discuss the following:

1. Triggering the Gift.
2. Avoiding Code § 2036.

Assigning an income interest in a QTIP trust is a tricky matter. The marital deduction rules might be read to prohibit an assignment. Contrast the last sentence of Code § 2056(b)(5) (permitting the spouse to appoint the trust’s assets while living) to Code § 2056(b)(7)(B) (ii)(I) (“no person has a power to appoint any part of the property to any person other than the surviving spouse”) and Reg. § 20.2056(b)-7(d)(1) (“the surviving spouse is included within the prohibited class of powerholders”). However, Code § 2519 expressly contemplates the surviving spouse making a disposition. See Reg. § 25.2519-1(g), Examples (3), (4) and (5). A very conservative approach would be to rely on the surviving spouse’s renouncing her interest in the trust’s income without accelerating the remaindermen’s interests.

The author mentions potential Code § 2036 issues. These issues are important, because Treas. Reg. § 25.2519-1(a) clarifies that a spouse who makes a disposition triggering a gift under Code § 2519 is deemed to have transferred the trust entire trust corpus for purposes of Code § 2036. The author cites various authorities on a donor being able to be a beneficiary without causing estate inclusion. (For more on the author’s views on the Code § 2036 risk in the context of a deemed transfer under Code § 2519, Bramwell, “Using Section 2519 to Enhance Estate Planning,” 38 Estate Planning 19-21 (October 2011).) These authorities assume that the trustee has uncontrolled discretion whether to make distributions to the donor and that there is no pattern of distributions. This strategy can work very well if an independent trustee is used and the spouse never intends to receive any future distributions. It might break down if the trustee is not independent and actually makes distributions, if the trustee is authorized to make distributions using an ascertainable standard, or if the surviving spouse has an annual right to withdraw 5% of the trust’s assets. If the clients are comfortable with principal distributions being in an independent trustee’s sole and absolute discretion without any standard (explaining to the client that this is intended as an emergency fund only even though the governing documents themselves have no such language) and state death tax planning seems important, then drafting for the “Section 2519 Portability Solution” can be quite beneficial.

The “Section 2519 Portability Solution” is more conservative than the surviving spouse creating a trust in which the surviving spouse is a beneficiary, because (depending on state law) the surviving spouse is not the settlor and therefore creditors’ attacks should be much
weaker. Furthermore, in many states, a self-settled spendthrift trust simply would not work, whereas the “Section 2519 Portability Solution” would be a viable option.

On the other hand, if giving the surviving spouse rights to principal distributions (using an ascertainable standard, through a 5% withdrawal right, or otherwise) or making the surviving spouse the trustee who decides to make distributions is important, then drafting for the “Section 2519 Portability Solution” might not be appropriate.

States imposing a death tax without a corresponding gift tax are leaving a gaping hole, which applies not only for this strategy but also for those taking advantage of portability in making gifts and those who go further by paying federal gift tax. This article is a good reminder to explore those issues.

The “Section 2519 Portability Solution” is a nice contribution to our thought process in planning under today’s crazy patchwork of federal and state estate taxes.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Austin Bramwell

TECHNICAL EDITOR: STEVE GORIN

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[i] The cause of the mismatch is that the Economic Growth and Tax Relief and Reconciliation Act of 2001 (“EGTRRA”) eliminated the federal state death tax credit for decedents dying after 2004. Before EGTRRA, most states had enacted "sop" or "pickup" taxes that were defined to be equal to the maximum allowable federal credit for state death taxes. Although in some states the elimination of the credit effectively eliminated any pickup tax, the pickup tax in other states, such as New York, remained frozen at the amount of the state death tax credit available under pre-EGTRRA law. Other states, such as Connecticut, have enacted their own, "stand-alone" estate taxes that are not tied to state death tax credit.

[ii] The New York taxable estate in this example is $5,580,454.55, or $460,454.55 more than the federal taxable estate. Even though the marital deduction is reduced to the extent that New York State estate tax is paid out of the marital share, the payment of New York State estate tax out of the marital share does not increase the federal taxable estate, as section 2058 of the Internal Revenue Code the ("Code") now allows a deduction for state death taxes payable. By contrast, the payment of New York State estate tax out of the marital share does increase the New York taxable estate, as New York does not recognize a deduction for state death taxes. To calculate the New York State estate tax due given a "reduce to zero" funding formula that causes the credit shelter portion to be exactly equal to $5.12 million, therefore, it is necessary to calculate that amount by which the New York taxable estate may be increased above $5.12 million such that the amount of the increase is exactly equal to the amount of the New York State estate tax. It turns out (with the help of some simple algebra) that this amount is $460,454.55.


[iv] A state-only QTIP election is not available in all states that impose an estate tax. New York, for example, only allows a state-only QTIP election if a federal estate tax return was not required to be filed and is not in fact filed. New York State Department of Taxation and Finance TSB-M-11(9)M; New York State Department of Taxation and Finance TSB-M-10(1)M.

[v] When the portability provisions were enacted, there was concern that the inherited exemption amount could be reduced if, for example, Congress lowered
the "basic" exclusion amount. American Bar Association Estate and Gift Tax Committee, Portability-Party One" at 10, available at http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/heckerling/2012/heckerling_report_2012_portability_part_one.authcheckdam.r
Bramwell and Kanaga, "The Section 2519 Portability Solution" at 14-15. Trusts & Estates, June 2012. Recently, however, the IRS has clarified that inherited exemption is not limited to the basic exclusion amount at the time of the surviving spouse's death but rather is only limited to the basic exclusion amount in effect in the year of the first decedent's death. Reg. 20.2010-2T(c)(1)(i).

[vii] In contrast to the federal estate tax, which has mechanisms, such as qualified domestic trusts or "QDOTs," for ensuring that estate tax deferred under the marital deduction is ultimately paid, states do not generally have the means to impose estate tax on surviving spouses who sever contacts with a state after the first decedent's death. Any attempt to impose such a tax might raise constitutional issues.

[viii] If a federal QTIP election is made, the first decedent's executors must make the so-called "reverse" QTIP election in order to cause the first decedent to be treated as the transferor of the swing share for GST tax purposes.

[ix] Until recently, there was a concern that tax on a lifetime gift by a surviving spouse could be recaptured at death if the surviving spouse remarried and survived a second spouse and thereby lost the exemption inherited from the first decedent. Temporary and proposed regulations have since clarified that the surviving spouse is deemed to use up inherited exemption before the "basic" exemption amount. Further, if the surviving spouse remarries and survives a second spouse, exemption inherited from the first decedent is still added to the surviving spouse's applicable exclusion amount to the extent that it was used in connection with prior gifts. Treas. Reg. § 20.2010-3T(b); Treas. Reg. § 25.2505-2T(c). In other words, exemption inherited from the first decedent cannot later be lost through remarriage and survival of another spouse, so long as it is actually used.

[x] Planners in a particular state (especially outside of New York) should review its death tax rules in order to confirm this conclusion.

[xi] Despite the significant transfer of wealth caused by grantor trust status, the grantor's payment of income taxes on the trust's taxable income is not a taxable gift. Rev. Rul. 2004-64. But see General Explanations of the Administration’s Fiscal Year 2013 Revenue Proposals (Feb. 2012) (proposing to subject grantor trusts to estate tax).

[xii] Blattmachr and Gans have also suggested an intriguing strategy that involves "undoing" a QTIP election under Rev. Proc. 2001-38. The new portability provisions, however, have thrown the validity of Rev. Proc. 2001-38 into doubt. Until the IRS clarifies the application of the Revenue Procedure, it does not appear that many couples will rely on it in order to defer or avoid state death taxes.

[xiii] It is unclear whether Section 2519 can be triggered before the QTIP election is actually made. By contrast, temporary and proposed regulations make clear that a surviving spouse can take advantage of inherited exemption even before the portability election is made, provided that the election is timely made. Treas. Reg. §§ 20.2010-3T(c) and 25.2505-2T(d).

[xiv] Rev. Rul. 2004-64; PLR 200944002; see also In re Uhl’s Estate, 241 F.2d 867 (7th Cir. 1957); Estate of German v. United States, 55 AFTR 2d 85-1577 (Ct. Cl. 1985); Rev. Rul. 76-103.

[xv] As suggested in Bramwell and Kanaga at 25 (footnote 40), to reduce risk of gross estate inclusion under section 2036(a)(1), the surviving spouse should wait a period of time before informing the trustee of the assignment of the income interest. It may also be prudent to change trustees so as to appoint someone with no prior knowledge of the assignment.

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[xvii] In New York, if the decedent made more than $900,000 of adjusted taxable gifts, the taxable estate must be $100,000 or smaller in order to reduce New York State estate tax to $0.

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